Financial Markets

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Irving Trust

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The markets sagged this week following news that first-quarter real GNP growth was at an even faster pace than was previously thought--9.7%--and a second-quarter "flash" estimate of 5.7% growth. This was bad news for the financial markets, even though it showed a strongly growing economy; to most people that would be considered good news. The adverse element for the markets was the continued rapid economic expansion in an economy that is viewed as beginning to approach capacity constraints. The operational question concerns whether the economy is growing too fast now for its own good in the future. What will the Fed think?

The likely Fed response depends on how the recovery is viewed. Last week I noted the bad news: fast growing money and credit. To this we now add faster than expected growth in consumer demand and in business investment. While there is no sign of inflationary pressure now (the "flash" estimate of the GNP deflator showed a modest 2.8% increase), the Fed's gaze is focused on the future. Capacity utilization rates now are high (82% for manufacturing), and the Fed views the dollar as precarious--about to tumble and spur inflation. A slowing in growth is sought to achieve a soft landing as full capacity is reached. So what should be done?

My preference would be for the Fed to stand pat. Rates are high, high relative to inflation. Money growth, however, has been rapid, averaging nearly 8% most of this year and having vastly overshot its original target for last year. Therefore, while some analysts point to rapid money growth and characterize the Fed's policy as expansionary, I look at interest rates relative to inflation and claim that the Fed has been tight. Unfortunately this argument doesn't impress the Fed. It seems determined to control money and credit growth, and, indeed, it seems recently to have tightened further.

In my view this policy has risks. Demand is strong, but the financial sector and foreign borrowers are vulnerable to rate increases. Let's remember that it is a Fed policy geared to control money and credit growth that is keeping the Fed funds rate high. It is this policy, in conjunction with credit demand, that is tugging on rates. Market participants hold expectations for future Fed policy, as well as for future credit growth, and these expectations affect rates today all along the yield curve. Moreover, let's not forget that interest rates impact the economy very gradually. Rates must be raised to very high levels to really stop the economy. Furthermore, we do not wish to stop the economy, just to slow it down. Current rates are doing the job, even if only slowly. Financial innovation in recent years has resulted in the discovery of 1001 different ways to index borrowings to short-term rates--for businesses and consumers. Credit is not crunched as it was in the past: no quantity rationing occurs. Credit is rationed by price alone, and this process works--but it's slow. The process squeezes financial intermediaries, LDCs, and corporations, unless their rate forecasts are excellent. Rates do slow the economy, but they affect a lot of other things as well. A strong case can be made for prudence, despite continued signs of strong economic growth.

Robert A. Brusca

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Market Yields

	6/22/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	12.50%	12.50%	10.50%
Effective since	5/8/84		
Discount Rate at Federal Reserve Bank	9.00	9.00	8.50
Federal Funds	11.69	11.13	9.00
Repurchase Agreements	10.38	10.75	8.88
U.S. Treasury Issues			
Bills			
3 months	10.30	10.25	9.32
6 months	11.43	11.08	9.61
1 year	12.37	11.80	9.86
Coupons			
2 years	13.22	12.66	10.41
4 years	13.61	13.04	10.73
7 years	13.73	13.21	10.96
10 years	13.77	13.23	10.96
Long Bond	13.62	13.16	11.01
Negotiable Certificates of Deposit-Secondary Market			
1 month	11.50	10.80	9.30
3 months	11.75	11.10	9.30
6 months	12.20	11.70	9.60
1 year	13.00	12.55	9.95
Banker's Acceptances			
1 month	11.62	11.00	9.24
3 months	12.00	11.22	9.42
6 months	12.43	11.92	9.64
Eurodollar Deposits			
1 month	12.13	11.31	9.63
2 months	12.25	11.38	9.75
3 months	12.75	11.56	9.75
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	10.80	10.87	8.63
1 month	11.26	11.00	9.33
3 months	11.25	11.09	9.34
Bank Holding Companies			
1 month	10.89	10.48	9.07
Dealer Placed:			
3 months	11.84	11.41	9.56
New AA Corporate Utility Bond	14.75	14.25	12.10
Tax Exempt			
6 month Project Notes	5.75	5.75	4.80
1 year AAA Bond	6.00	6.40	5.10
5 year AAA Bond	8.05	8.10	6.50
20 year AAA Bond	10.00	10.00	9.40

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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